Ukraine. Monthly Market Overview
January 2014

Ukraine Sovereign Ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa1	B-
Short-term	B	-	
Outlook	Negative	Negative	Negative
FCY rating			
Long-term	B	Caa1	B
Short-term	B		B
Outlook	Stable	Negative	Negative
Latest assessment	26/12/13	20/09/13	08/11/13

Financial Markets team

CRÉDIT AGRICOLE

Major Macroeconomic Trends

MACROECONOMIC INDICATORS - evolution

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013E*	2014F*	2015F*
Nominal GDP	(USDbn)	38.0	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	177	192	205
Real GDP growth	(%)	9.2	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	-0.7	1.8	2.9
Inflation CPI	(%)	6.1	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	5.0	7.0
Industrial production	(%)	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.5	2.8	2.5
Producer Prices index	(%) YoY			7.6	20.5	16.7	9.6	19.5	35.5	6.5	20.9	19.0	0.3	4.7	5.6	5.5
Exports	(USDbn)	20.1	23.4	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	72.2	77.6	83.6
Imports	(USDbn)	17.7	21.5	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	90.4	93.6	96.6
Public debt	(% of GDP)	37.1	33.5	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	35.8	37.0	38.8	39.2	39.0
Current account	(% of GDP)	3.7	7.5	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.5	-7.9	-6.6	-4.7
Net FDI inflow over year NBU methodology	(USDbn),	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.6	3.8	3.7	4.6

EXCHANGE RATES - evolution

USD/UAH average	5.37	5.33	5.333	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	8.36	8.88
EUR/UAH average	5.1	5.02	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	10.76	11.18
UAH O/N average	16	3.5	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	2.5	1.9

- ***The deal is done and the Ukrainian president had finally chosen the Ukrainian external policy at least for the medium term***. In particular, Ukraine is on its way to receiving financial assistance of USD15bn as well as a discount on Russian gas of 30% from the start of 2014. In return, Ukraine has refused any agreements with the EU while making obligations to move towards a Customs union in the near future. We think ***the deal with Russia reduces the economic freedom of Ukraine in the medium-term future***, while the conditions of the loan and gas price discount raise the dependence of Ukraine on Russian policy.

- ***The upcoming receipt of USD15.0bn from Russia may reduce the rationale for the government to implement core IMF requirements***, especially taking into consideration that their implementation will increase social tensions in the country on the eve of presidential elections. Hence, the probability of resuming stand-by loan provision to Ukraine in the coming year is declining. At the same time, ***this does not increase the default risk of the country for the coming two years*** as Ukraine will cover its external financial obligations with its Russian loan.

- As more and more specific details of the Russia-Ukraine deal are becoming public, they just support our view that the core ***outcome of the agreements reached would be just a postponement of economic turmoil in Ukraine after the election period, ie to end-2015/early-2016***.

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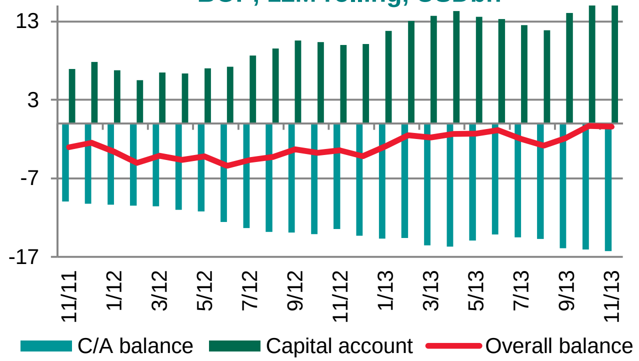
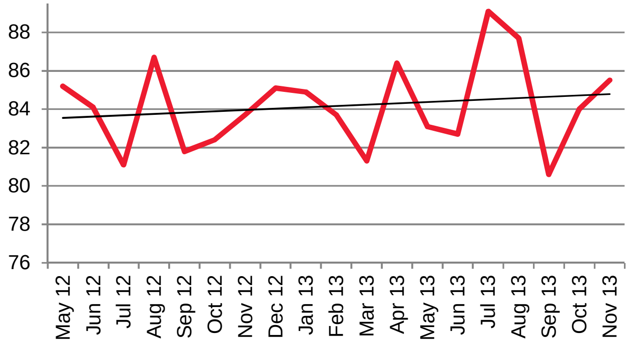
Major Macroeconomic Trends

BOP, 12M rolling, USDbn



Sources: NBU, Credit Agricole

Consumer confidence index



Source: GFK Ukraine

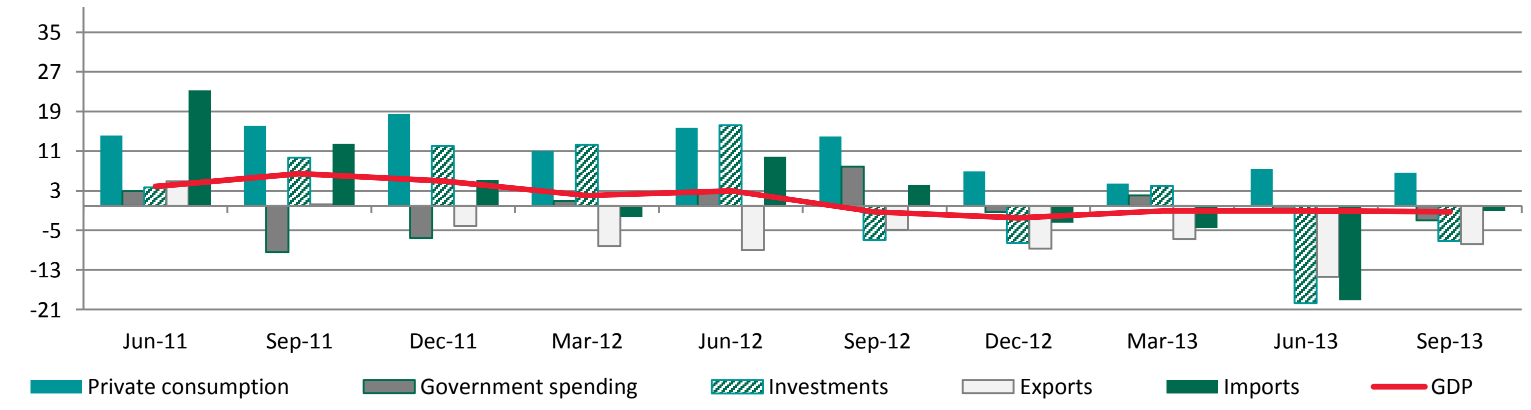
Forecasts	GDP, % YoY
Q413	**0.7%**
Q114	**1.9%**
Q214	**2.6%**
Q314	**1.9%**

Source: Credit Agricole

- ***Even though the current account deficit showed a visible improvement in November (USD1.09bn versus USD1.96bn in October), it did not yet reflect the recovery in domestic exports*** following the significant shock coming from the trade war with Russia. Instead, Ukraine did not pay fully for its gas deliveries thus agreeing with Russia to postpone the payments for 2014. Because BOP statistics do not reflect financial flows to the IMF, the capital account remained positive in November (USD0.45bn) albeit visibly worse than the month before (USD1.46bn). ***The receipt of the loan from Russia at the end of December should visibly improve the BOP over the full-year 2013 and in the coming year,*** thus postponing the rationale for UAH weakening for 6-12 months. The discount on Russian gas prices (effective from 2014) as well as tighter economic cooperation with Russia will also improve the CA in 2014.
- The financial assistance from Russia of USD15.0bn as well as around a 30% discount on the Russian gas price led ***S&P to improve its 12-month outlook regarding the Ukrainian sovereign rating from Negative to Stable***. The decision is quite understandable on the back of an absence of much default risk in the coming 12 months due to the expected improvement in the BOP after Ukraine and Russia reached an agreement on economic cooperation. However, the decision of the rating agency did not improve the country risk levels as the Russia-Ukraine deals were already priced in by the market. ***An improvement in the rating outlook by two other rating agencies may follow soon, although we are unlikely to see any rating upgrades in the near future*** as financial assistance from Russia is rather short-term.
- ***The updated figure for GDP dynamics over Q313 shows a slight improvement in its decline to 1.3% YoY***. On the expenditures side only private consumption contributed to GDP growth over Q313 (6.7% YoY). At the same time, investment dynamics improved greatly in Q313 (-7.1% YoY) versus Q213 (-19.7%) due to the elimination of the Euro-2012 effect since the middle of 2012. We think this improvement will continue in Q413 and Q114 as some investment projects were finished in Q313 and Q413. However, due to the improved performance of investments we can see a further worsening in net exports in Q413 due to the inability to restore exports greatly with a simultaneous increase in imports. In any case, ***GDP may show a little growth in the last quarter*** on the back of the low comparison base of last year and due to a significant upturn in agriculture performance in 2013.
- ***Because three economic sectors: agriculture, transport and trade already showed growth in YoY terms (42.2%, 2.4% and 2.2%, respectively) in November, economic dynamics have switched to the positive area***. It is also worth noting that other sectors slowed their YoY rates of decline in November compared to October. We think the improved performance in the majority of sectors occurred due to the low comparison base effect against last year. That is, GDP dropped by 2.5% YoY over Q412. The dynamics of the economic sector in November still leave us hope we will see GDP growth over Q413. At the same time, the political crisis in December may reduce the positive GDP dynamics in the last quarter of 2013. Thus ***we downgrade our Q413 GDP growth forecast to 0.7% YoY and have lowered our full-year forecast to -0.7% YoY***.

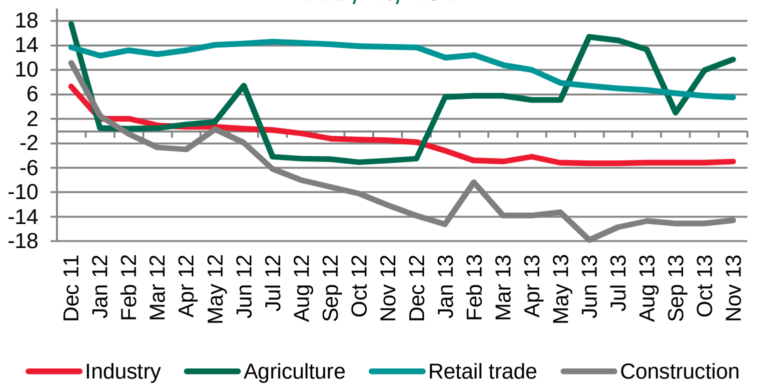
Major Macroeconomic Trends

Quarterly GDP dynamics by expenditure components, %, YoY



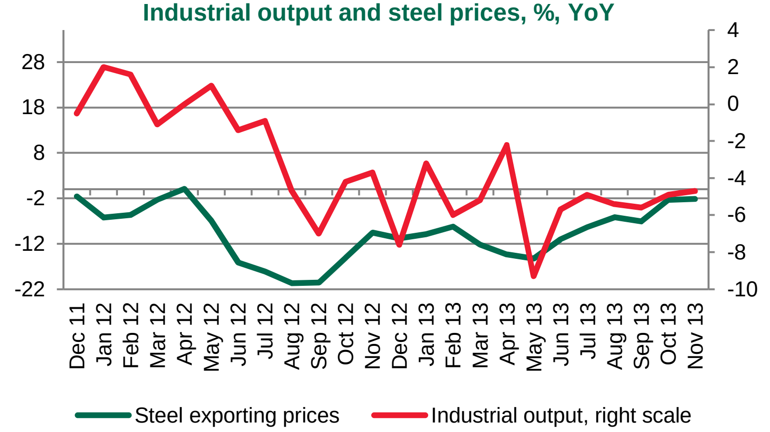
Sources: State Statistics Committee

Performance of major economic sectors, YTD, %, YoY



Source: State Statistics Committee

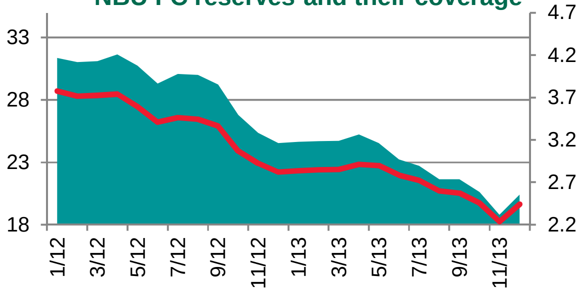
Industrial output and steel prices, %, YoY



Sources: State Statistics Committee, Bloomberg, Credit Agricole

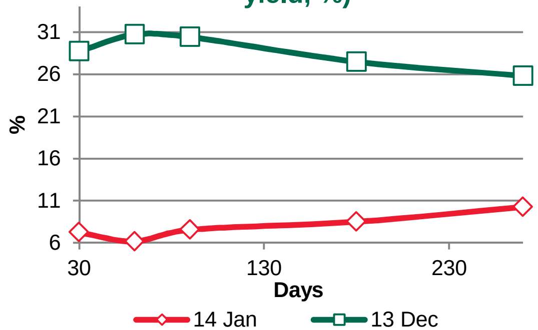
Ukraine. Monthly Market Overview. January 2014
FX Market

NBU FC reserves and their coverage



Sources: NBU, Credit Agricole

USD/UAH NDF curve (implied yield, %)



Source: Bloomberg

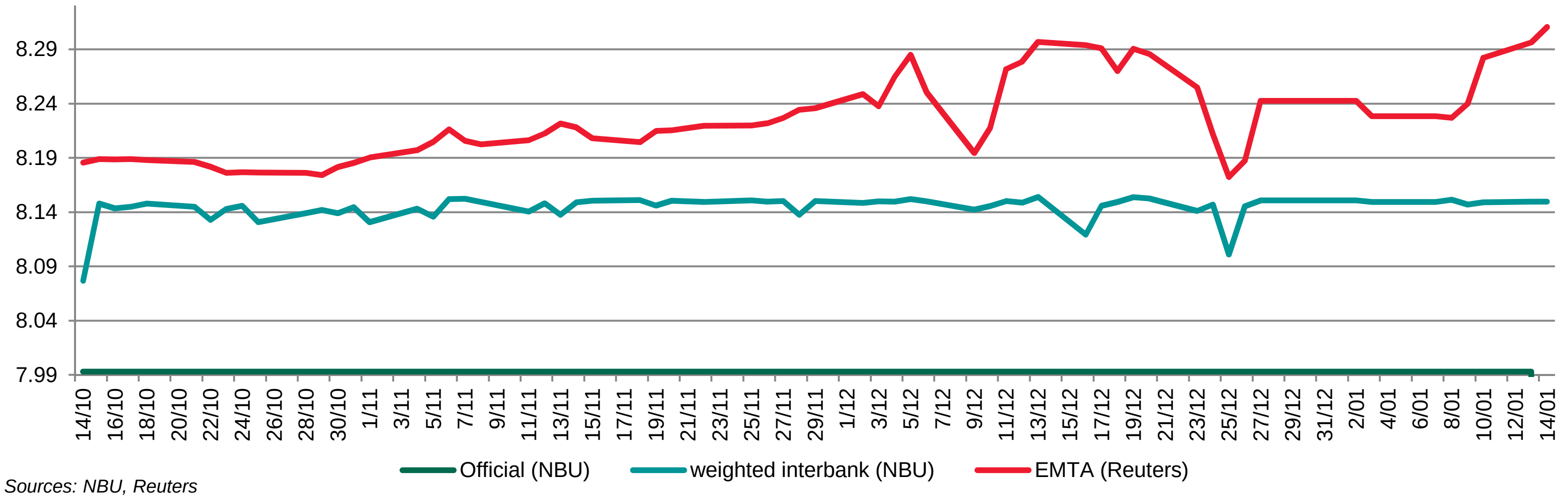
Forecast, eop	USD/UAH	EUR/UAH
Q1'14	8.33	11.16
Q2'14	8.38	11.06
Q3'14	8.46	11.00
Q4'14	8.47	10.84

Source: Credit Agricole

- ***Political instability at the beginning of December affected all segments of the FX market*** thus raising devaluation fears there and leading market participants to purchase foreign currency in advance. The market instability came first from the cash FX market due to growing uncertainty among households regarding the path of the exchange rate in the near future.
- It is necessary to give proper respect to the ***NBU, which promised to keep financial market stability***. ***And it has succeeded in its short-term strategy*** by applying both market (interventions) and non-market (administrative pressure, hryvnia liquidity squeezing) mechanisms. These measures prevented sharp volatility in the FX market thus keeping the USD/UAH exchange rate within a range of 8.1725-8.2969. Nevertheless the pressure from excessive demand pushed the rate up to 8.27-8.30 for the majority of days in December.
- Another turn in exchange rate dynamics occurred at end-December when a successful agreement on Russian financial assistance removed immediate devaluation fears from the market and moved the USD/UAH exchange rate to 8.17-8.19. ***The inflow of USD3.0bn from Russia by the year-end provided a good foreign currency buffer for NBU reserves and it became the core factor for the National Bank to move the USD/UAH exchange rate downwards at the end of December***. However this trend was not sustainable as rapidly replenishing UAH liquidity, a seasonally low volume of mandatory foreign currency sales and fears among market participants of inevitable UAH weakening brought about another upward movement in the USD/UAH rate to 8.32-8.33 in mid-January. We think this is just a temporary phenomenon, and it is tied to the seasonally low supply of foreign currency by exporters due to the New Year holidays. Hence, this gap should be eliminated soon.
- ***Disregarding the balance of supply and demand in the FX market, we think the USD/UAH rate will remain relatively stable in the coming months***. This should be achieved mostly by NBU policy preventing any significant shocks in the FX market, especially in the pre-election period. The expected upcoming loan of USD12.0bn from Russia would be another supporting factor for the USD/UAH rate in the coming months. Additionally, a 30% discount on the Russian gas price, lifting the limitations on Ukrainian exports into Russia as well as increasing economic cooperation between the two countries should improve the BOP in the coming month or two, thus removing fundamental factors for any sound UAH devaluation in the near term. Therefore, ***we expect a rather flat exchange rate forecast for the end of Q114***.
- ***NBU FC reserves recorded a visible increase over December*** (by 8.7% MoM to USD20.4bn). The provision of USD3.0bn via Eurobond issuance by Russia was the core reason behind the growing dynamics of foreign currency reserves in December. At the same time, the necessity to repay the debt of USD0.75bn to the Russian bank as well as heavy support of the FX market (especially its cash segment) in early December reduced the pace of NBU reserves' growth last month.
- ***Growing reserves increased their coverage of imports slightly to 2.4 months*** versus the ten-year minimum of 2.2 months in November. ***The dynamics of NBU FC reserves in January will depend greatly on the additional financial assistance that should be provided by Russia soon***. In the event of no assistance, the reserves will face a downward movement again mostly due to the repayment of debt to the IMF in late January (USD0.65bn).

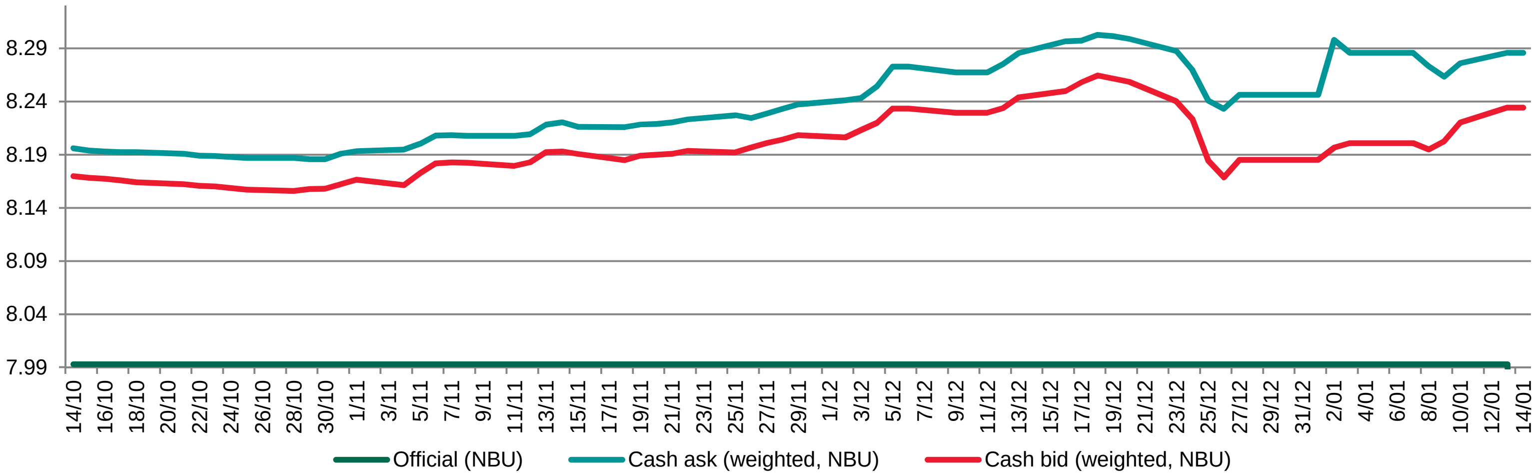
FX Market

USD/UAH interbank exchange rate over last 3 months



Sources: NBU, Reuters

USD/UAH cash exchange rate over last 3 months



Source: NBU

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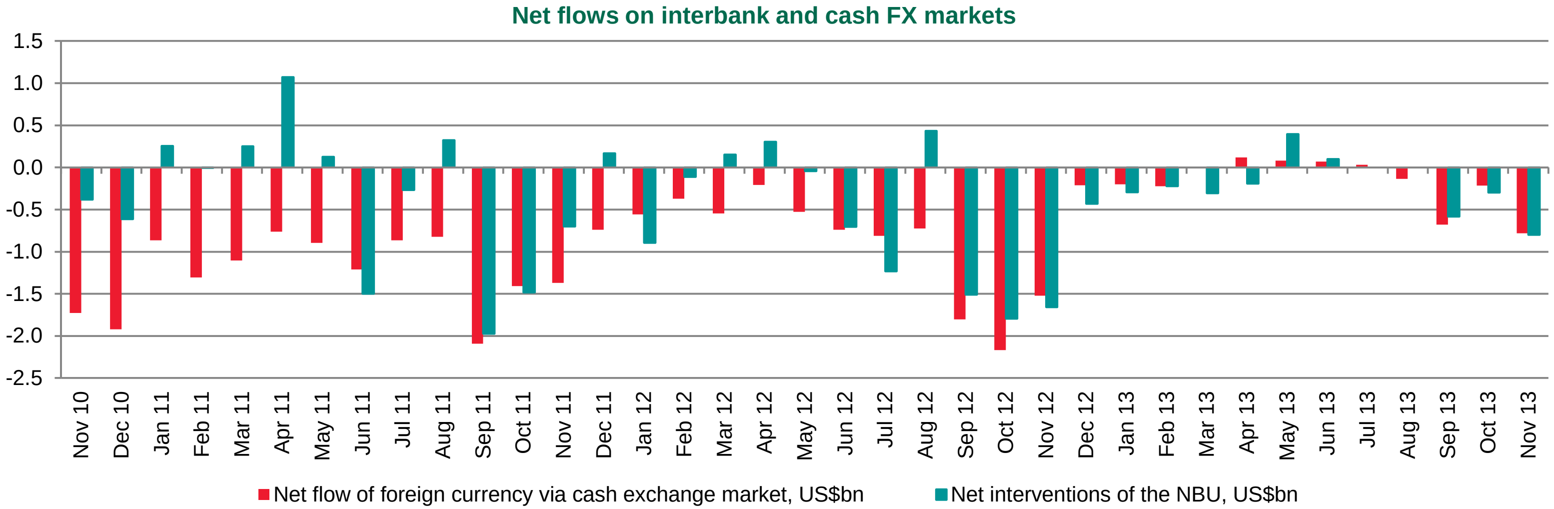
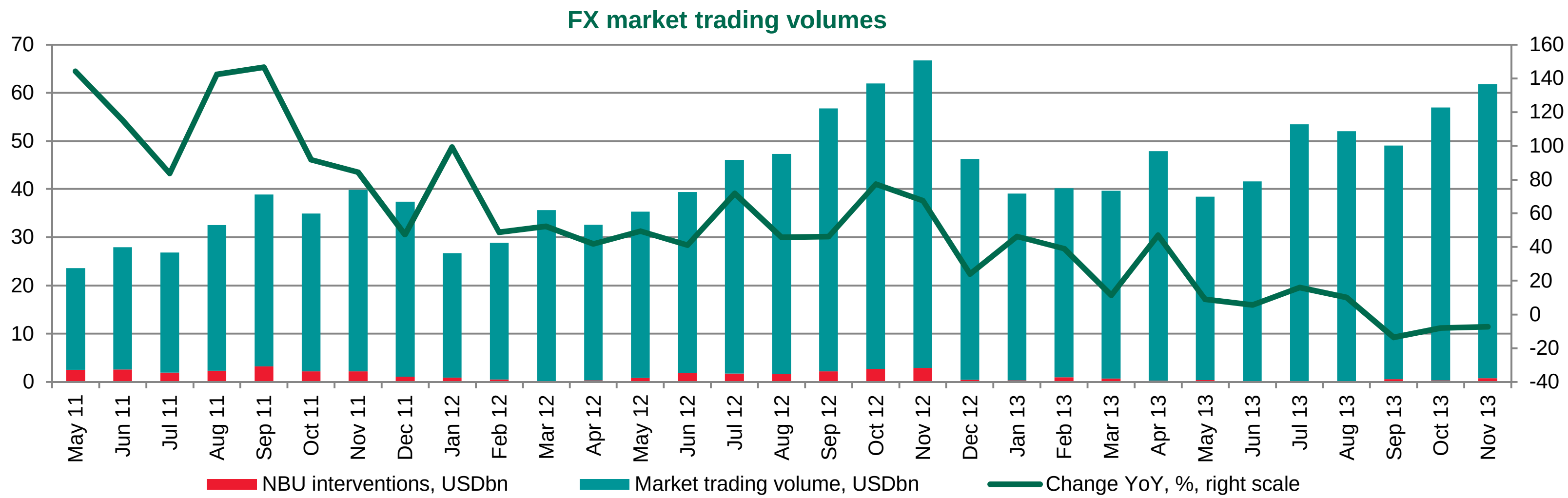
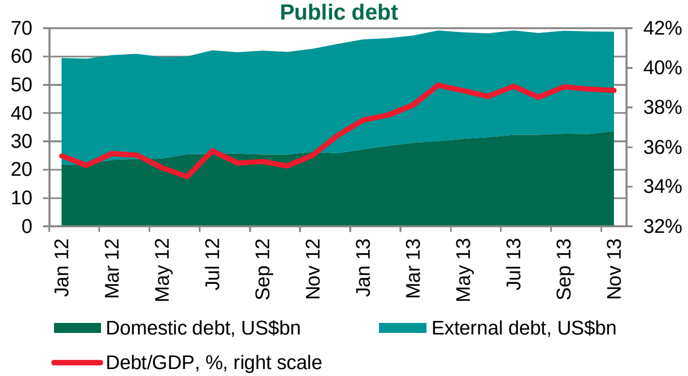
FX Market

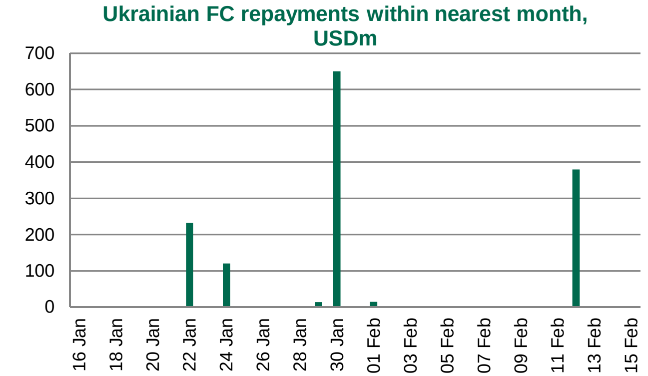




Ukraine. Monthly Market Overview. January 2014
Debt indicators



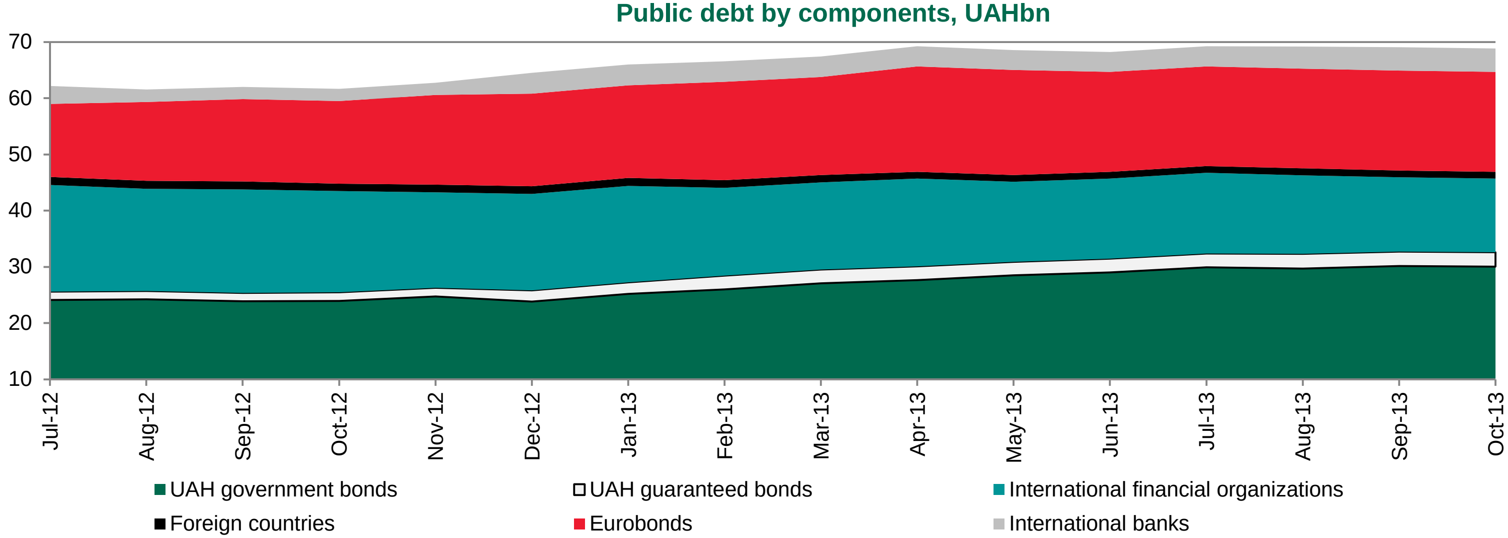
Sources: Finance Ministry, Credit Agricole



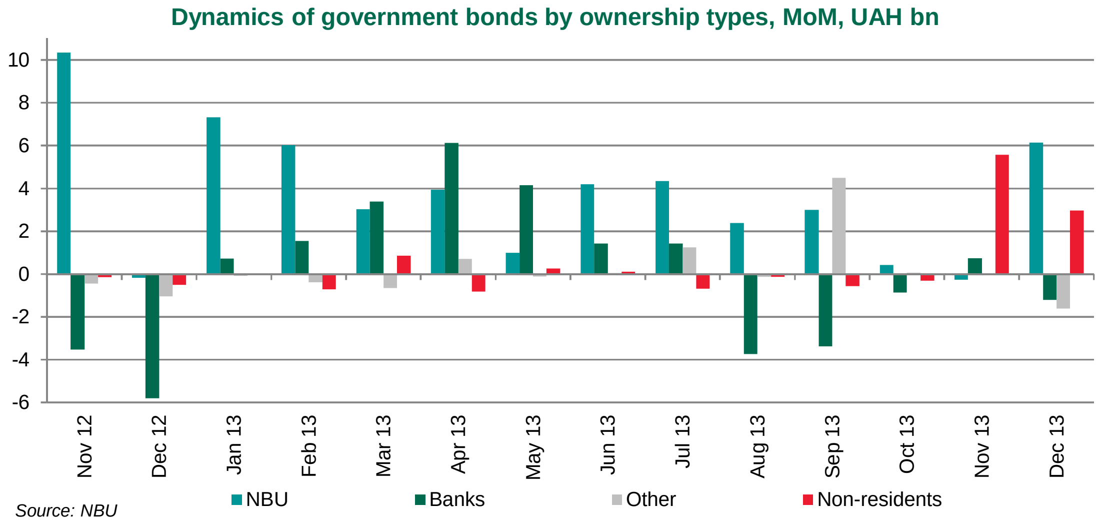
Sources: Finance Ministry, Credit Agricole

- The redemption of debt to the IMF ***reduced the level of public debt slightly in November while still keeping moderate growth in YoY terms (9.6% to USD687bn)***. However, only the external part of public debt was on a declining track in November (-3.2% MoM) while the widening budget deficit forced the government to continue its active domestic borrowing .
- A slight decline in public debt ***lowered the debt-to-GDP ratio to 38.9% in November thus still staying in a comfortable zone in terms of the ability of the government to service its obligations in the medium term***. We think the debt figure will show a visible hike over December due to the receipt of new debt of USD3.0bn from Russia as well as a continuation of active domestic borrowing.
- ***As Russia agreed to provide the first portion of its loan (USD3.0bn) to Ukraine in 2013, Ukraine issued Eurobonds in late December***. However Ukraine already had to repay USD0.75bn back to Russian banks a few days after the Eurobond issuance. It is worth noticing that according to governmental decree the loan of USD0.75bn was borrowed in September for a term of two years while the truth is that it was a multi-stage short-term loan with first maturity in three and a half months post issuance.
- The issuance of one-week local foreign currency bonds in December worth around USD0.2bn does not mark the introduction of a new market instrument. Instead we view it as a kind of bridge loan provided by Russian banks in anticipation of an inflow of USD3.0bn through Eurobonds. Hence, the redemption of these local bonds was not a problem for the budget in late December. ***As more foreign currency resources may come from Russia in January, we think the government will reduce its activity in foreign currency borrowings (both domestically and externally) in the coming three to six months***.
- Beyond the solid positive effect of the Russian loan on the ability of the government to service its obligations in the coming two years, it also raises certain risks for the government in the medium term. In particular, the ***provision of the full USD15bn to Ukraine will increase the concentration of Ukrainian debt in the hands of one creditor***. For example, the share of Ukrainian public external debt held by Russian state institutions and banks will be increased to an enormous 55%. Additionally, the provision of a short-term loan to Ukraine (for a term of 2-3 years) ***will sharply reduce the duration of external debt*** thus increasing repayment risks for the government until late 2015.
- The agreements reached between Ukraine and Russia regarding the provision of USD15.0bn have ***considerably reduced default risks for the country for the time being and removed them for 1.5 to 2 years ahead***. Hence, Ukrainian CDS dropped by 360bp in one day and reached a seven-month low of 686bp at the beginning of 2014.
- Even though the decision by Russia to provide a USD15.0bn loan to Ukraine reduced country risk tremendously, ***we do not think the government will use this opportunity to enter global capital markets with a new issue in order to diversify its debt portfolio and to increase its duration***. Because the loan from Russia is more than enough to cover Ukrainian external obligations for 2014 (including the obligations of state-guaranteed debt), which total around USD10bn, the government will not seek new external financing sources, in our view.

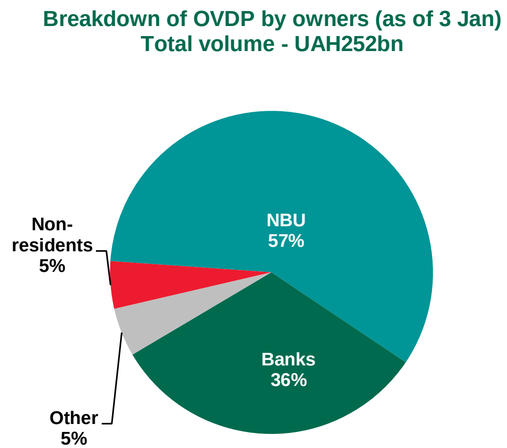
Debt indicators



Source: Finance Ministry



Source: NBU

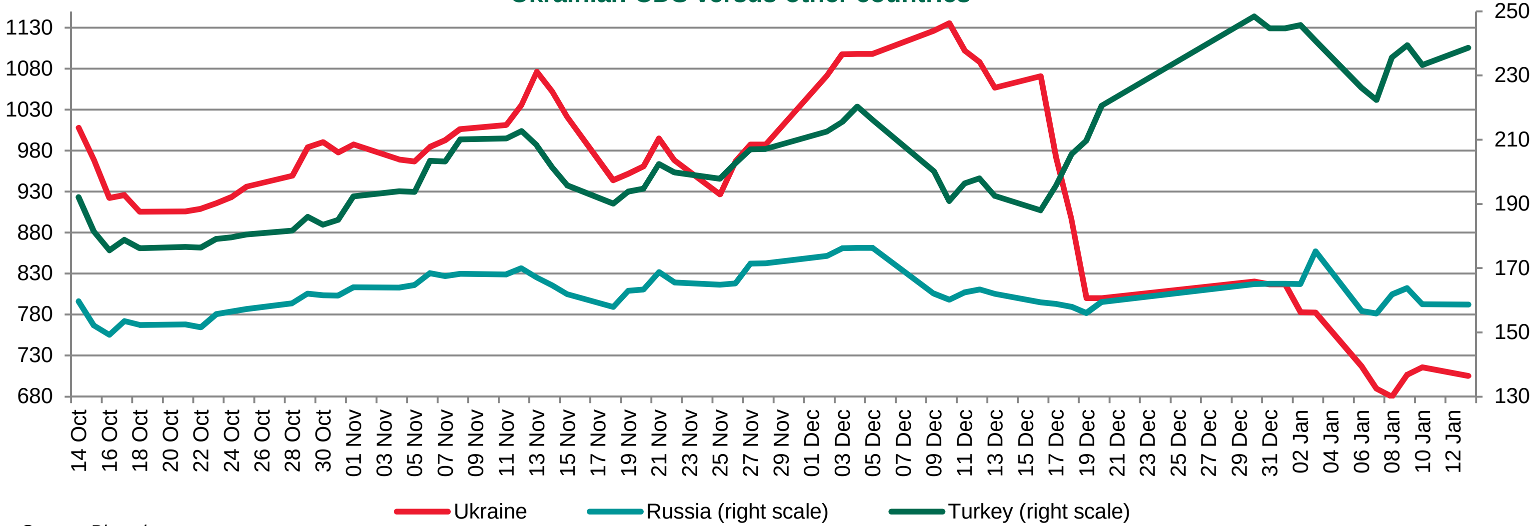


Source: NBU

Ukraine. Monthly Market Overview. January 2014

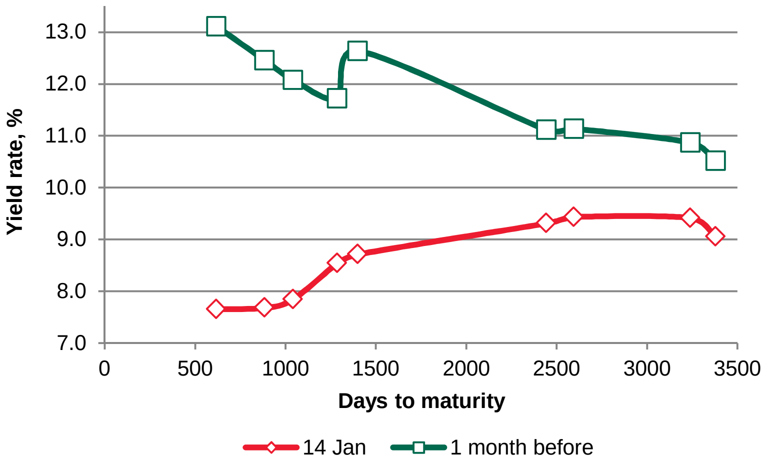
Debt indicators

Ukrainian CDS versus other countries



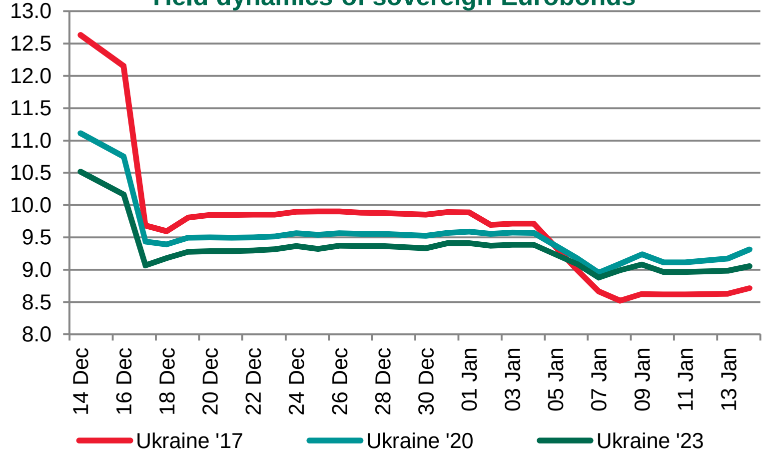
Source: Bloomberg

Ukraine's sovereign Eurobonds yield curve



Source: Bloomberg

Yield dynamics of sovereign Eurobonds

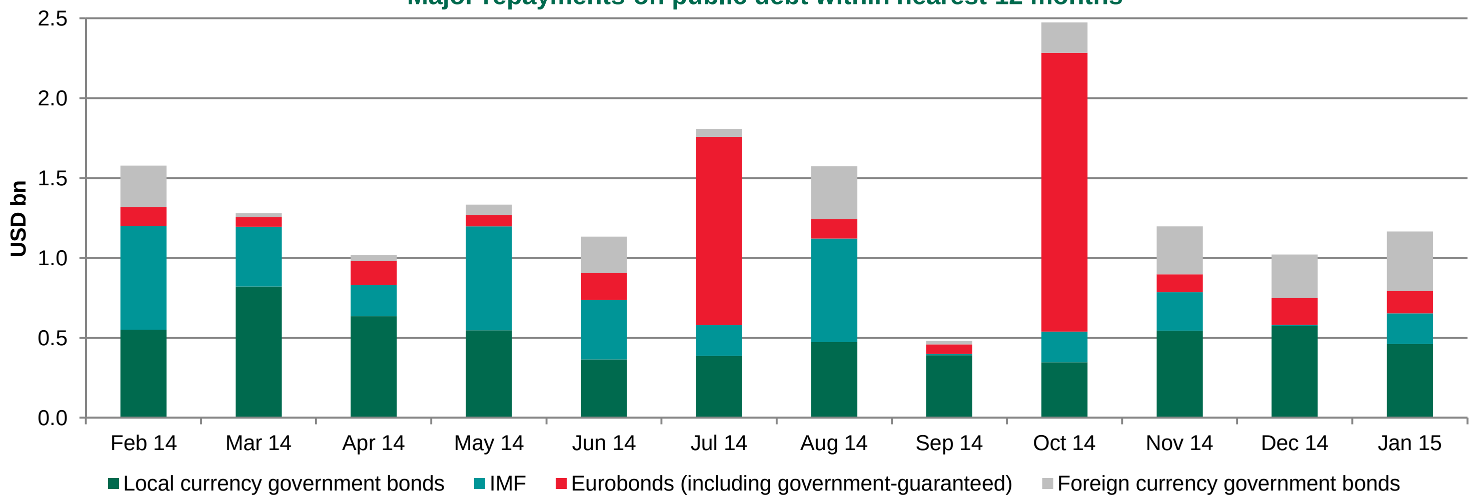


Source: Bloomberg

Ukraine. Monthly Market Overview. January 2014
Debt indicators

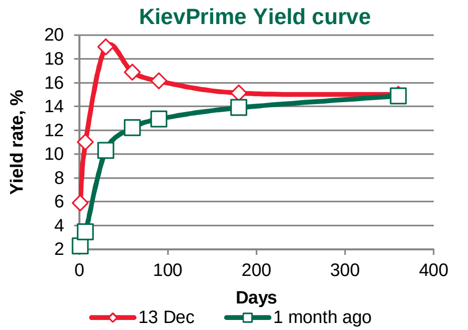
USDbn	Q114	Q214	Q314	Q414	2014
Repayment of FC denominated public debt	**1.6**	**2.2**	**3.7**	**3.7**	**11.0**
foreign currency local government bonds	0.3	0.3	0.5	1.0	2.2
IMF debt	1.2	1.2	0.9	0.4	3.7
Eurobonds (including state-guaranteed)	0.3	1.4	1.9	0.4	4.1
other	0.4	0.2	0.3	0.1	1.0

Major repayments on public debt within nearest 12 months

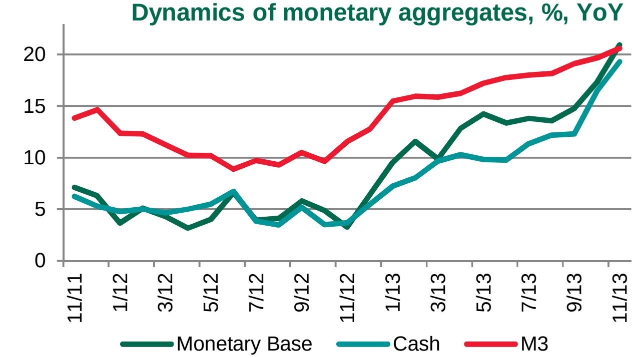


Source: Credit Agricole

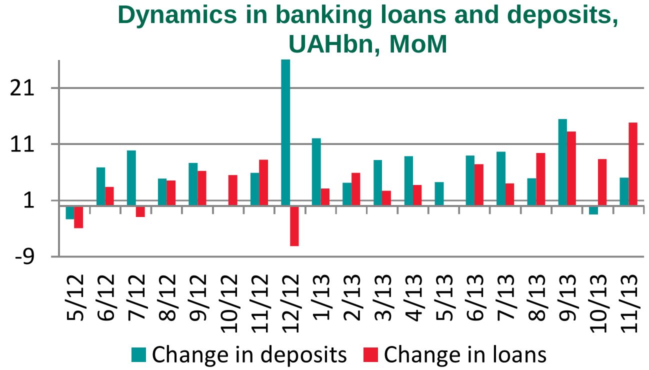
Money Market



Source: Bloomberg



Source: NBU



Source: NBU

- Even though the money market was relatively stable for the majority of days in 2013, interest rate dynamics in December show that the stability is not sustainable and may be ruined rather quickly. Hence, the ***inability of the NBU to contain excessive foreign currency demand via interventions and administrative restrictions has forced the national bank to return to its practice of squeezing money market liquidity*** in order to remove excessive pressure for foreign currency. Additionally, the State treasury blocked the hryvnia accumulated in its account at the NBU, thus not transferring it into the banking system. As a result, banking balances with NBU have slid sharply behind the comfort level of UAH25.0bn to a seven-month minimum of UAH19.8bn, thus forcing short-term interest rates to explode and to transform the yield curve into an inverse shape.
- It seems NBU officials understood the negative impact monetary tightening may have on money market dynamics and banking system operations. Hence, the ***sharp liquidity deficit did not last for long, and as soon as NBU managed to reduce foreign currency demand, banking system liquidity started to return to its comfort level*** thus allowing interest rates to correct downwards. The NBU also provided refinancing to certain banks thus allowing them to pass the year-end period painlessly. Nevertheless, fears of a new liquidity squeeze as well as growing seasonal demand for hryvnia prevented short-term rates from declining below 8-10% in December. ***Only the seasonal decline in demand for hryvnia in early December as well as the inflow of liquidity from treasury accounts allowed the money market to return to its normal mode*** by lowering O/N and 1W rates to 2.3-2.5% and 3.5-3.6%, respectively.
- ***CPI stayed rather close to zero over 2013 (0.5% YoY)***, which we can attribute mostly to administrative control over prices. In fact, public utility tariffs were frozen throughout the whole year (0.3% YoY) while the price of food products even showed a slight decline over the year (-0.7%). We think the pre-election period will restrain any solid growth in consumer prices in the coming year. However, the easy monetary policy of the NBU will keep inflation on an upward track. Hence, ***we expect CPI to grow by 5.0% YoY in 2014***.
- ***We do not see any rationale currently for the NBU to take a wrong turning and change its medium-term monetary policy towards tightening***. Low inflation levels (both headline and core) indicate the absence of solid obstacles preventing the NBU from following monetary easing. The receipt of financial assistance from Russia as well as the anticipated improvement in the CA should reduce the risks for UAH weakening thus removing the necessity for the NBU to reduce excessive hryvnia liquidity in the market. Hence, ***we do not expect any sharp and long-lasting upward movements in short-term interest rates in the near future***, with the only exception of moderate hikes on the back of seasonal factors (eg, month-end). Therefore, a ***rather flat and low-volatility interest rate environment is a likely scenario for coming weeks***.
- As NBU is likely to continue its monetary easing, we can see the implementation of some additional measures like, for example, a ***reduction in reserve requirements or a cut in the key rate***.

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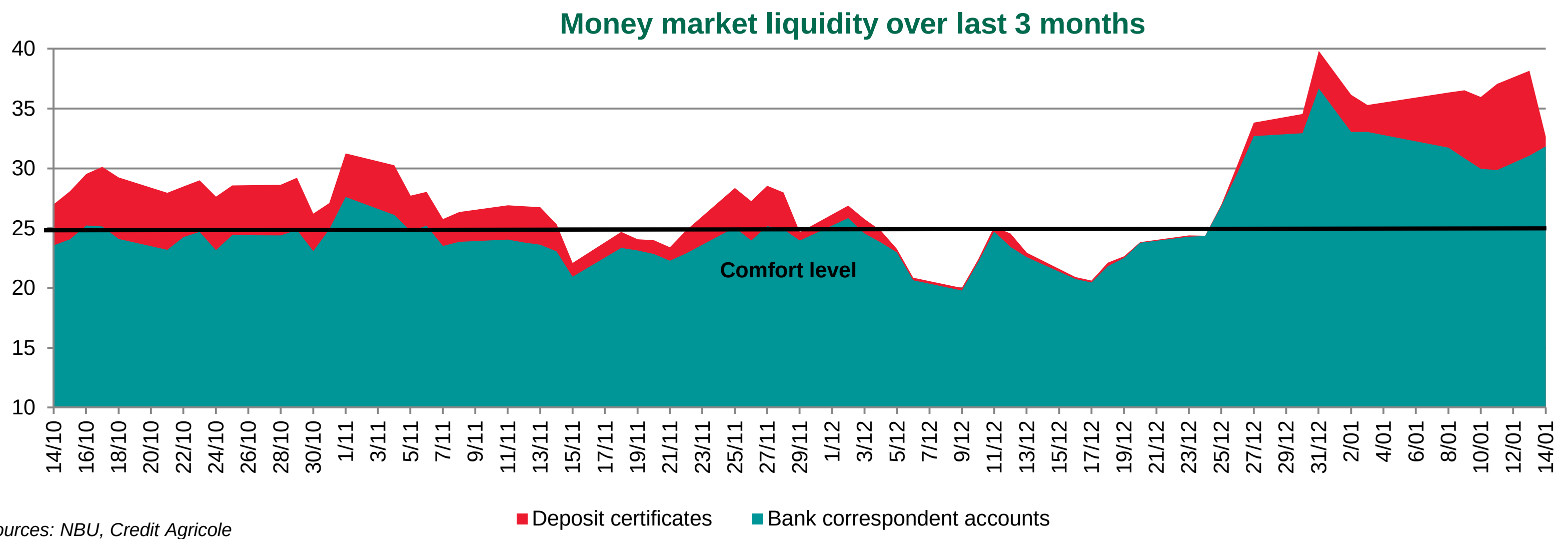
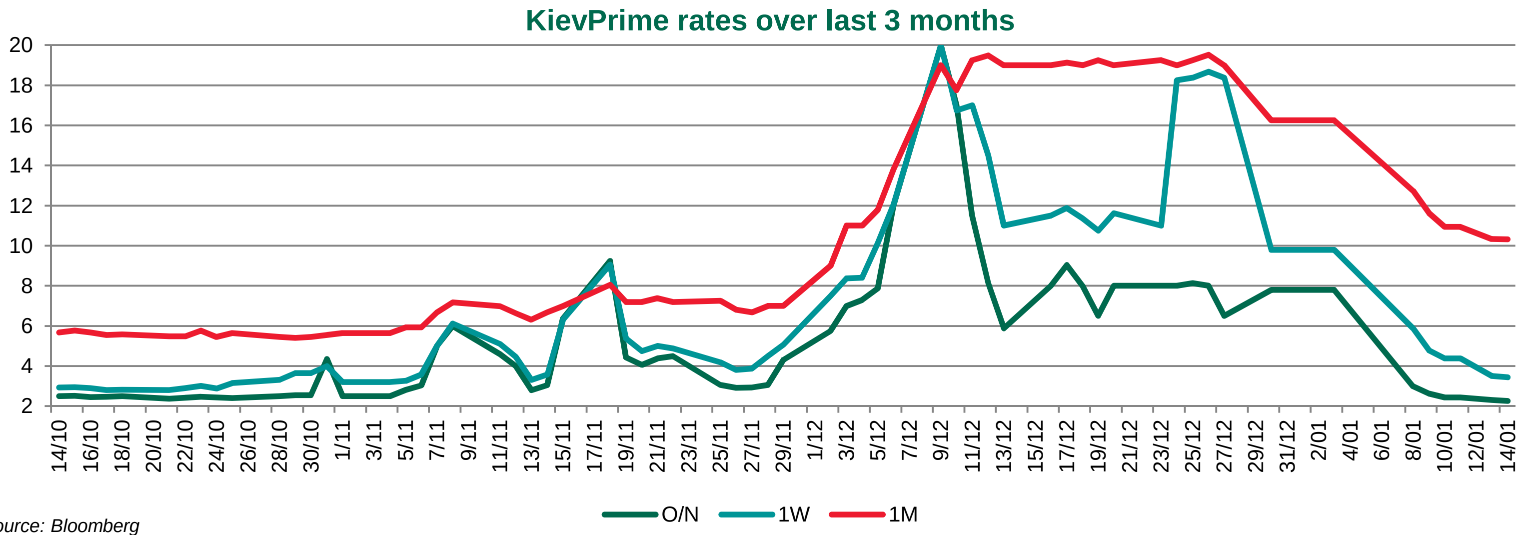
Money Market



Sources: NBU, Credit Agricole



Source: Bloomberg

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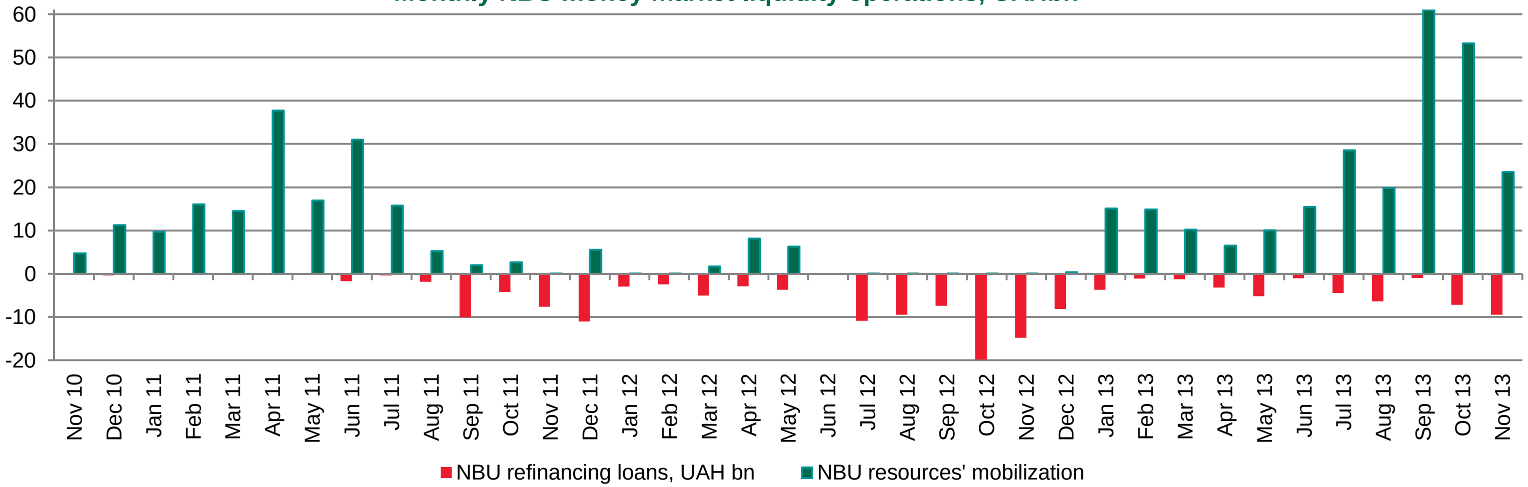
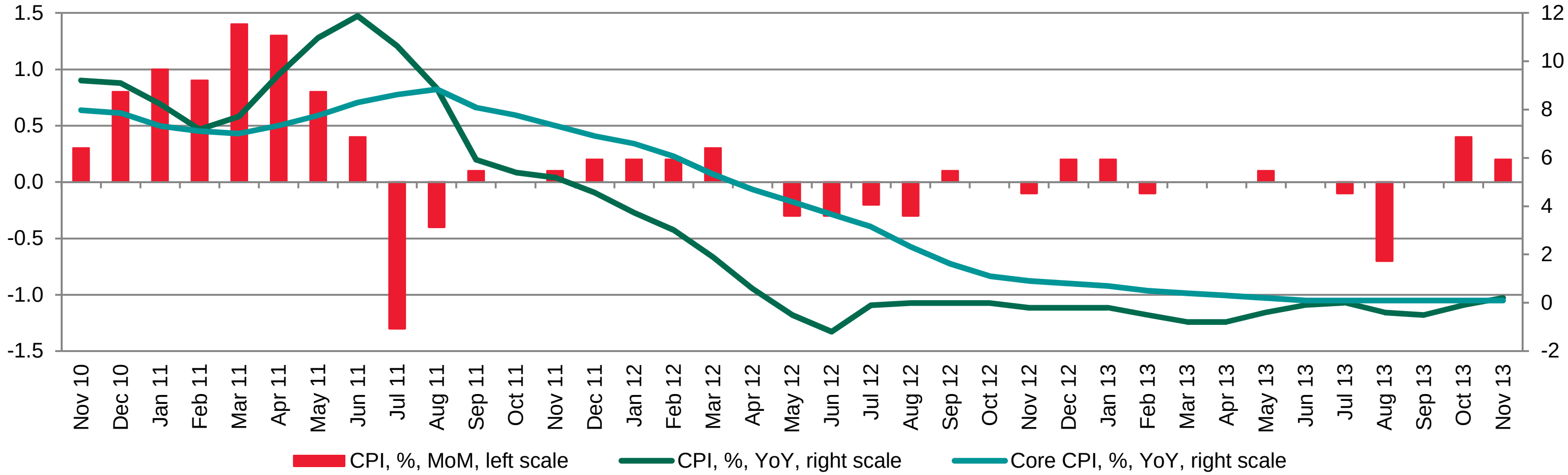
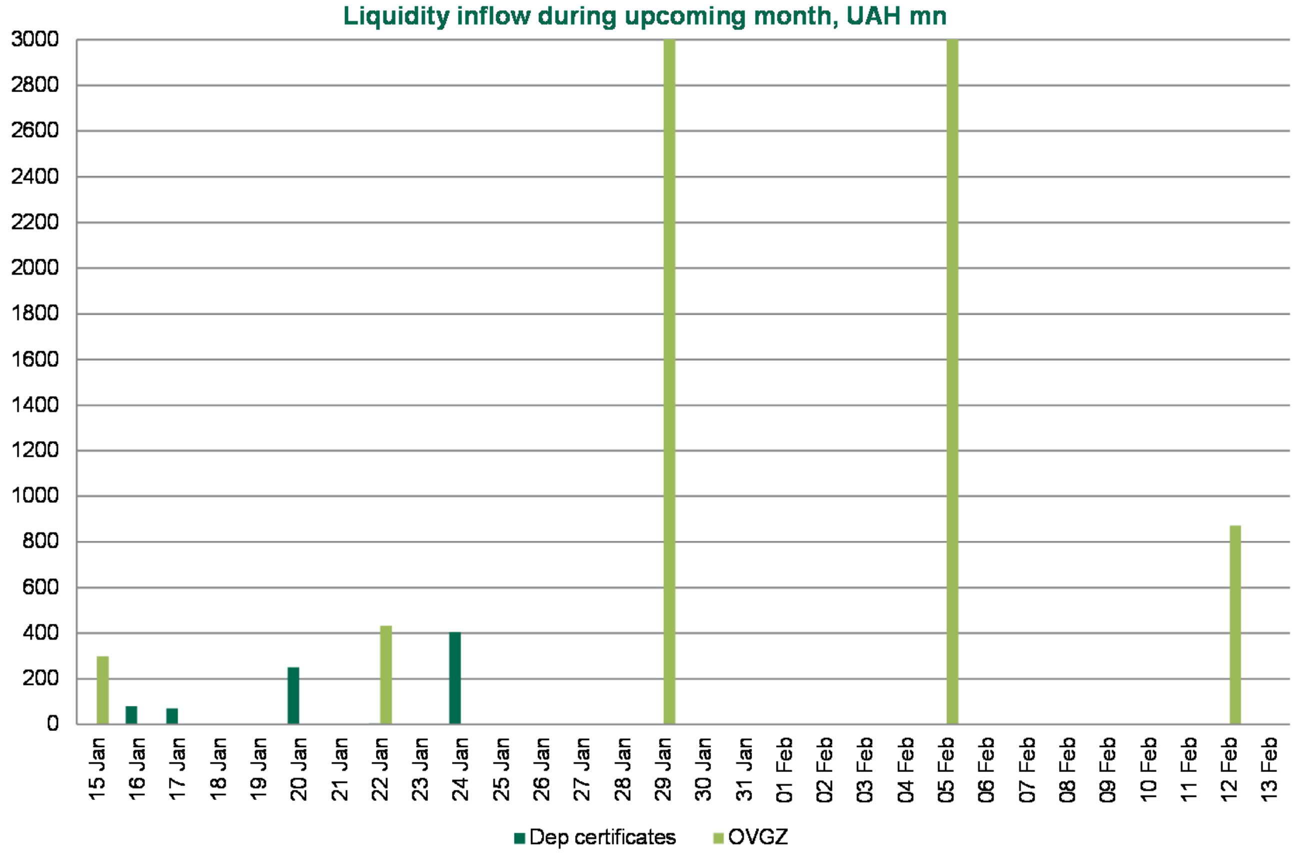




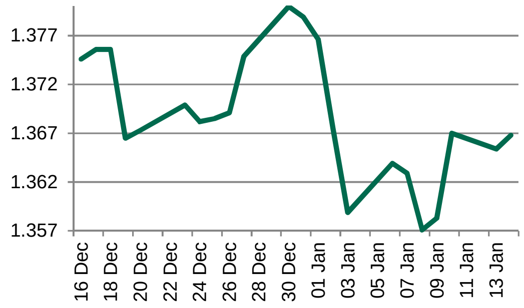
Source: State Statistics Committee

Money Market



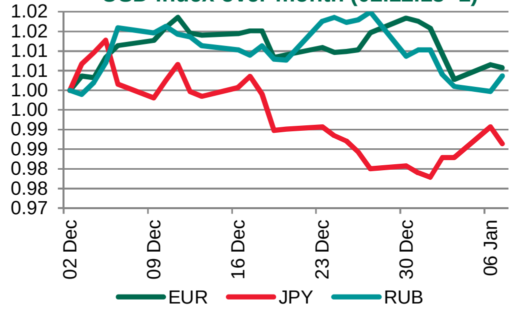
Sources: NBU, Finance Ministry, Credit Agricole

EUR/USD over last month



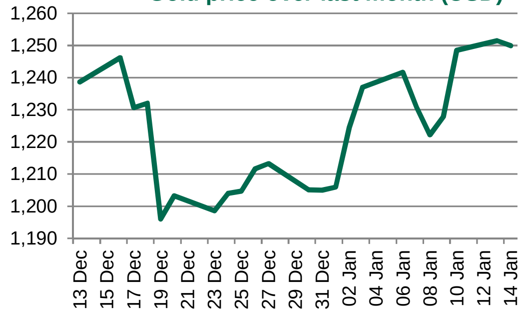
Source: Bloomberg

USD index over month (02.12.13=1)



Sources: Bloomberg, Credit Agricole

Gold price over last month (USD)



Source: Bloomberg

- The EUR/USD closed the month on a high note at 1.3758 as traders sold off the USD and moved to equities. There has been very little in the way of positive data to show a recovery in the Eurozone except for words from ECB's Draghi. Banking has taken some steps forward but otherwise the Eurozone remains stagnant with the exception of Germany. The higher EUR will have a negative effect on exports and will in turn weigh on the entire zone. Rhetoric reinforcing the likelihood of continued 'tapering' of the Fed's QE3 program in the months ahead is likely to boost the USD against most of its top counterparts. A more cautious tone stressing the data dependence of near-term policy may yield the opposite effect. The rate-setting FOMC committee began to scale down stimulus in December, reducing asset purchases by a cumulative USD10bn.

- Driving the renewed USD strength is the anticipation that US economic growth this year will outpace the recovery in Europe and other regions, which would boost the USD's value by attracting more cash to US shores. As the economy heals, the Federal Reserve is expected to continue reducing, or 'tapering' its stimulus program, a move that also helps the USD because it slows the injection of new money into the financial system.

The following are adjusted market forecasts:

Crédit Agricole CIB EUR/USD forecast:

Q114	Q214	Q314	Q414
1.3300	**1.3000**	**1.2900**	**1.2800**

Consensus forecast (Bloomberg FC Poll by 85 strategists average)

Q114	Q214	Q314	Q414
1.3400	**1.3200**	**1.3000**	**1.2800**

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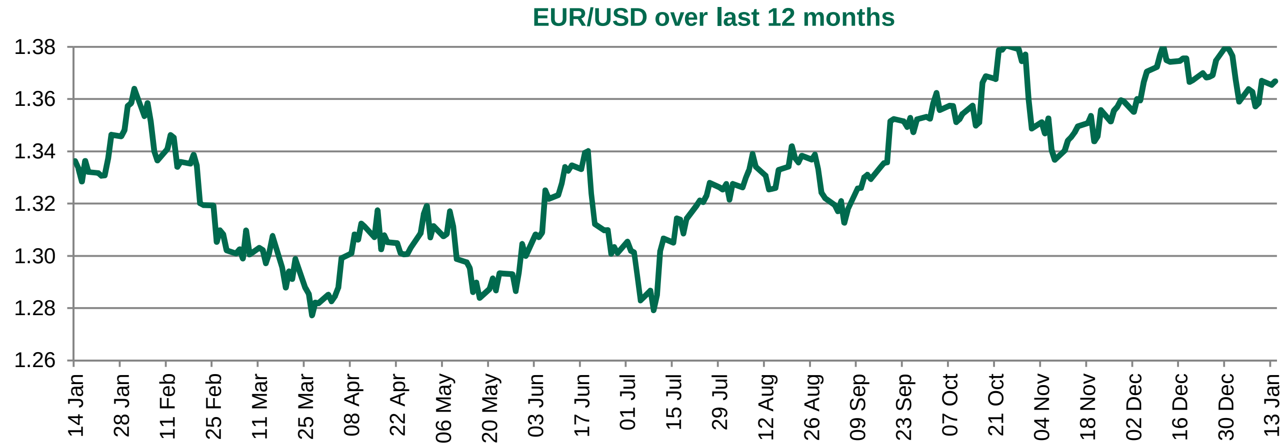
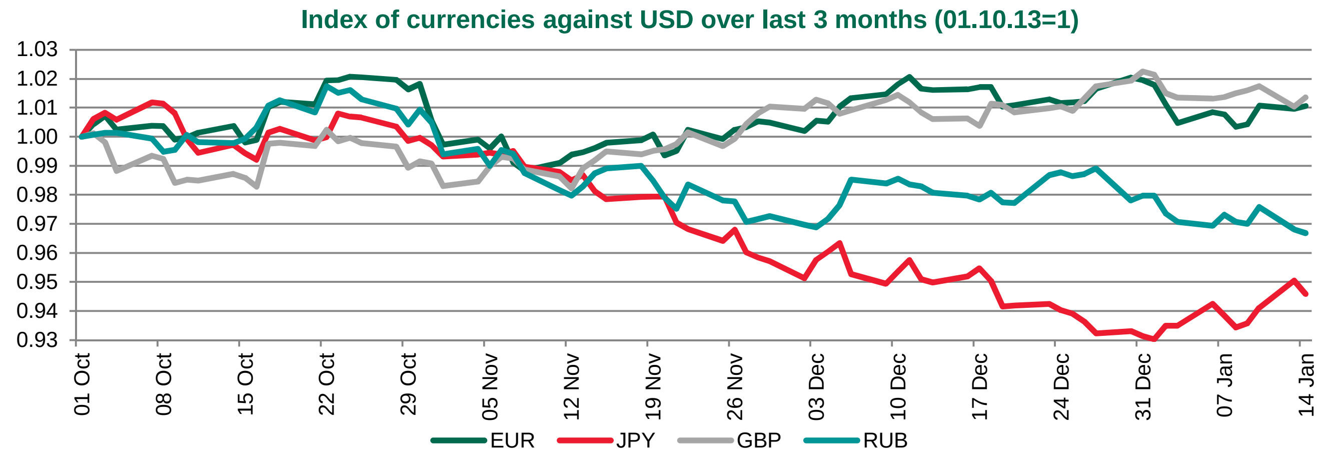


Source: Bloomberg



Sources: Bloomberg, Credit Agricole

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